Master's Thesis

ARE POLITICAL CONNECTIONS IMPORTANT FOR FIRM PERFORMANCE?

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Abstract

We explore the influence of political connections on the firm performance. An analysis of data from 395 Korean listed firms in manufacturing sector during 2011-2015 reveals that firms with high levels of political connections and such presence are negatively related to Tobin Q, operating cash flow, and ROA, supporting the rubber stamp perspective. An important implication is that Korean firms appointing former officials as outside directors are prone to negatively affect performance. In other words, instead of hiring former government officials to take advantages from the government, firms in Korea should consider and appoint experts rather than political connections outside-directors in order to increase their performance.

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1. Introduction

Menon and Williams (1994) argued that the adoption of an outside director system is not important. The most important aspect is the operation of independence, activities and expertise of outside directors. In 2000, outside directors were introduced in Korea, but concerns about outside directors are increasing steadily as the expertise of outside directors, appointment procedures, and uncertainties of outside directors are increasing. According to a survey by the Financial Supervisory Service (FSS) on the status of "Outside directors' management of publicly traded corporations" on March 29, 2007, the attendance rate at the board meeting was 70.5% at the end of March and Top 100 companies with market cap amount to 86.7% are just maintaining the framework of the system. However, when we look at the actual situation of operation, the story is different. This is because many companies are still running out of sight. Only about 40 companies (2.9% of the 1403 companies) submitted their dissenting opinions or amendments on the board's agenda last year**.** Furthermore, as a result of researching the composition of outside directors, the top five group companies newly elected and reappointed 38.46% (number is 91 of 237) of the outside directors from the bureaucracy (Munhwa-ilbo, November 29, 2007).

Are political connections always beneficial for firm performance? This research question is my main focus. This study explores the firm performance implications of political connections in the Korean context because such connections are important factors affecting the performance of Korean firms. Even if several researches have empirically explored the influence of political connections on corporate performance, whether political connections have a positive or negative influence on corporate performance remains an open question. Previous empirical evidence is inconclusive and contradictory (Su and Fung, 2013). Some researchers have highlighted the need for addressing how political connections may contribute to firm performance in other context (e.g., Faccio, Masulis, and McConnell, 2006; Fan, Won, and Zhang, 2007; Chizema, Liu, Lu, and Gao, 2015; Zheng, Singh, and Mitchell, 2015).

To answer an aforementioned question, this study conducted an analysis of 395 Korean listed manufacturing firms for 2011-2015. South Korean offers an interesting context as Korean firms tend to significantly emphasize political connections to take benefits from the government and to have higher performance. The findings from the analysis suggest the following: former government officials on the outside-directors and the political directors' presence are negatively related to Tobin's Q and operating cash flow (OCF), suggesting that high ratios of political directors and such presence are more likely to be harmful for firm value and OCF. On the other hand, high ratio of politicians on the outside-directors are insignificantly related to accounting performance (ROA), whereas the

presence of the political directors are more likely to negatively influence accounting performance. These findings highlight that the important role of political connections for firm performance.

I make some contributions to the empirical literature. First, such findings contribute to the understanding regarding of the political connections-performance relationship in South Korea. I offer the clear evidence that the high level of political connections and the political directors' presence may hurt firm performance. Despite the common belief and theoretical assumption that political connections are crucial for achieving high performance, Fan et al. (2007), Su and Fung (2013), Chizema et al. (2015), and Zheng et al. (2015) provide few insights into this link as they have chiefly concentrated on the Chinese firm performance. On the contrary to Su and Fung (2013)'s research, my findings suggest that political connections negatively influence firm performance, filling the gaps between empirical evidence and theoretical argument by exploring performance implications of political connections in Korea. Second, we use the longitudinal data set to reduce the omitted variable concern that plagues the political connection' studies. I also provide a more united model of political connections on corporate performance by considering several performance variables: for instance, Tobin's Q which reflects market value, Operating Cash Flow as cash generating-ability from operating activities, and Return on Asset which reflects accounting based performance.

This study is similar to the Su and Fung (2013) and Lim, Huh, Bae, and Jeong (2015)'s thesis. However, there are differences in the following points. First, Su and Fung (2013) used Cash holding, Tobin's Q, and ROA as a substitute variable of performance. Lim et al. (2015) consider only Q of Tobin as a substitute variable of performance. However, this study uses Tobin Q, ROA as well as operating cash flow that reflects cash flows. Second, this study finds that industries with high political relevance are Construction Field (67%), Electronics, Gas, Steam, and Water Supply (60%), and Professional, Scientific, and Technical Activities (56%) in order in Korea. But Su and Fung (2013) and Lim et al. (2015) have not considered the political connections of industries. Third, in this study, the analysis was conducted for companies listed in KOSPI from 2011 to 2015, and Su and Fung (2013) analyzed from 2004 to 2008 in China's firm and Lim et al. (2015) analyzed from 2000 to 2010 in Korea's firm. Lim et al. (2015) showed no significant relation. However, we differ in that it shows a significant negative relation using more recent data.

The remainder of this study consists of the followings. In Section 2, this research describes the relevant literature between political connections and corporate performance. In Section 3 explains the sampling process, build a model for empirical analysis, and examine the variables introduced. In Section 4, I show the results of the empirical analysis and show interpretations and implications. Finally, section 5 summarizes and concludes and presents this study's limitations and scope for future studies.

2. Literature Reviews

In this chapter, we consider the relation between political connections and corporate performance. The results of previous studies showed mixed findings of impacts of political connections. There are two conflicting perspectives on the role of political directors (Kang and Zhang, 2015). One is the monitoring/advising view. This view is that political directors play a significant role in increasing corporate value through monitoring activities. The other is the rubber stamp view. This is not the role of political directors to monitor and advise, but rather to take the role of unconditional support for CEO decisions. Some studies have reported that political connections have a positive influence on corporate performance, while others have found that corporate performance is negatively influenced by political connections.

2.1 The Positive Impact of Political Connections on Corporate Performance

There is a positive relation between political connections and corporate performance which can be inferred from the view that political directors play a role of monitoring within a firm. Research reports the positive effects of political connections on corporate performance focuses on the role of outside directors. Studies on the outside directors have been actively examined so far. For example, Fama (1980) argued that outside directors monitor and control managers to motivate them to make decisions for shareholder interests. Fama and Jensen (1983) noted that outside directors control the management and participate in board decisions, eventually increasing shareholders' wealth by reducing agency problems.

Many research reported that political relations have a positive impact on firm performance. In particular, it is expected that companies will obtain benefit from the selection of former government officials among various professional outside directors. For example, Hillman, Zardkoohi, and Bierman (1999) argued that political directors can provide important links and confidential policy information. They noted that because the public policy process is complex, costly and difficult, government officials can improve company performance by promoting sales to the government through unique information on political connections and public policy processes. Agrawal and Knoeber (2001) found that government oversight can reduce government enforcement and influence government action on corporate profits due to contacts obtained while working in the public sector. It is absolutely useful when regulatory action is particularly important, for instance the Food and Drug Administration. Su and Fung (2013) analyzed that firms with political affiliations have a positive influence on cash holdings and corporate performance (ROA, Tobin Q) for Chinese firms.

In addition, many previous studies have verified that companies can gain the benefits from close links with politicians A firm with political relevance has priority in accessing credit and maintaining government contracts (e.g., Leuz and Oberholzer-Gee, 2006; Goldman, Rocholl, and So, 2009). Faccio (2006) noted that politically linked firms receive government bailouts in the financial sector. Adhikari, Derashid, and Zhang (2006) and Faccio (2006, 2010) found that companies with political affiliations are paying lower taxes and gaining preferential benefits via going public. In addition, political directors have even improved their accounting and financial performance directly (e.g., Goldman et al., 2009; Cooper, Gulen, and Ovtchinnikov, 2010). Lastly, Hellman, Jones, and Kaufmann (2003) analyzed that politically linked companies could easily secure property rights.

Therefore, political directors play a significant role in value-enhancing firms' decision making as effective monitors/advisors, in particular when they do business in a regulatory environment or when companies preserve a main trading association with the government. As a result, companies with political connections are expected to show higher corporate performance due to these benefits.

2.2 The Negative Impact of Political Connections on Corporate Performance

Some studies have found that firms with political connections have a positive impact on firm performance. On the other hand, a lot of researches have analyzed the negative relationship. The evidence that there is a negative relation between government connections and firm performance can be inferred from the view that Political directors are acting as rubber stamp views within the firm.

A rubber stamp view indicates that the political directors are an ineffective monitoring / advice perspective. This is due to the fact that government supervisors tend to have less business experience in finance, accounting and corporate governance. The lack of accounting and financial knowledge will reach the limits in terms of monitoring and advice. Employees must have a different set of skills when they become political directors in government agencies and private companies. Government agencies that spend more time with government and lack of business and industry experience can make it difficult to understand how government agencies affect investment and financial decisions.

If the government lacks experience with firms or lacks accounting knowledge of finance and governance, the effect of monitor/advisors on the company is likely to decline. Custodio and Metzger (2013) analyzed that increasing the shareholders' assets in the acquisition process led to the CEOs of the acquired companies. Cohen, Krishnamoorthy, and Wright (2010) examined the relation between advisory activities and effective monitoring of the board and firm performance. In addition, Badolato, Donelson, and Ege (2014) analyzed that the relation between audit committees with financial expertise and earnings management. They found that audit committees with financial expertise made

low earnings management.

The above papers argued that the board of directors can increase the value of the firm by accounting and financial experts. Moreover, CEOs may hire elderly government officials because their salary can be low, but they have other private benefits like their relation with older government officials, which they can obtain a lot of information from their relationship with them. However, political directors can be more intimate with CEOs, less likely to face management and actively participate in disciplining management (Hwang and Kim, 2009; Bruynseels and Cardinaels, 2014; Clune, Hermanson, Tompkins, and Ye, 2014). CEOs who appointed these political directors may be less constrained than those of firms appointing non-political directors.

There is an empirical analysis in which political connections have a negative influence on performance.

For instance, Kang and Zhang (2015) investigated the role of outside directors with government experience (government directors) at the corporate board. They found that government directors were prone to miss the board meetings and that the announcement of appointment was greeted negatively. They also found that unlike other outside directors, the attending of the CEO's board did not affect the performance of CEO sales. In addition, firms with government directors have poor business results and announcements of merger have negative consequences. However, these companies are less likely to be taxed and mergers brought up by antitrust authorities. Using the instrumental variable approach to control for endogenous bias does not change the outcome. They also found that the opposite effects of government oversight are greatly mitigated when corporate have high government sales, operate in controlled industries, or have politically connected government directors.

Lim et al. (2015) analyzed that firm value of the companies with ex-bureaucrat outside directors are significantly higher in average and median than companies without ex-bureaucrat outside directors. However, when the properties of companies and the board of the directors, which have been reported to influence firm value, are controlled, no significant differences are observed. To the contrary to their expectation, they do not find significant differences in firm value between when firms without ex-bureaucrat outside directors appoint former bureaucrats as outside directors and when companies with ex-bureaucrat outside directors do not re-appoint them as outside directors. Furthermore, the firms with higher percentage of ex-bureaucrat outside directors are significantly lower in firm value than the firms with lower percentage of ex-bureaucrat outside directors.

Nonetheless, only few studies excepting Lim et al. (2015) have explored the influence of political connections on the performance among firms in Korea. In this way, political connections negatively influence on firm performance. As a result, it can be seen that there is no consistent result between political connections and corporate performance. Especially, research on this subject is rare in Korea.

3. Data and Method

3.1 Data Sampling

In this study, this paper is to analyze the relation between political directors and corporate performance (Tobin's Q, OCF, and ROA) through hand-collected data from 2011 to 2015.
Firstly, I collect a sample of political connections outside board data from DART (through Registered Officer Status). We define political connections of outside-directors as Political directors. This study classified Political directors as below:

Political directors' definition:

1) If registered outside directors are former government official, they are classified as political director.
2) If registered outside directors experienced various job, but experienced government official at least once, they are classified as political directors.
3) Professors, accountant and journalist are not classified as political directors.

After obtaining political connections data, we have 1,975 observations in KOSPI. Secondly, we collect accounting and financial data from TS-2000 dataset (It is similar to COMPUSTAT in USA) and matching the political connections data. After that, I delete omitted observations. Finally, we obtain 1,580 observations (395 samples) in this paper.

I selected sample companies below criteria.

1) Select only KOSPI listed firms
2) Excludes companies that are unable to obtain financial and political director data for TS2000 and DART from January 1, 2011 to December 31, 2015.
3) Excludes banking, securities, insurance, etc. from the sample companies because they differ from general manufacturing in terms of capital structure, operating method, and government regulation supervision.
4) Companies do not have cash and cash equivalent assets or whose assets are less than one billion won or whose sales are not included are excluded from the sample because they may cause abnormalities in the variables.
5) To dilute the effect of outlier on the analysis results, 1% of the upper and lower levels of the

dependent variables were winsorized.

Furthermore, I give independent variables to time-lagged. This is because it can reduce the effect of political linkage on the corporate value of causal relationships. Table 1 shows descriptive statistics. Table 2 summarizes the industrial classification.

3.2 Model and Variable Definitions

3.2.1 Analysis Model of Tobin's Q (Market performance)

We use below panel least square model that has been widely utilized in researches to examine the relation between political directors and market-based performance. We use the following panel model to measure market-based performance.

(1)

$$\textit{Tobin's } Q_{it+1} = \beta_0 + \beta_1 \times \textit{Political Dummy (or Political Ratio)}_{it} + \beta_2 \times FFO_{it} + \beta_3 \times \textit{Board Independence}_{it} + \beta_4 \times \textit{Board Size}_{it} + \beta_5 \times OCF_{it} + \beta_6 \times LEV_{it} + \beta_7 \times PPE_{it} + \beta_8 \times SIZE_{it} + \beta_9 \times AGE_{it} + \varepsilon_{it}$$

Where,

Tobin's Q_{it+1}	=	is operationalized as asset book value, less equity book value, plus the equity market value, divided by asset book value at time.
Political Dummy	=	is a dummy that if at least one Political director on the board we coded 1, 0 otherwise at time.
Political Ratio	=	is the number of political director divided by number of board of directors at time.
FFO	=	is operationalized as foreigner ownership at time.
Board Independence	=	is operationalized as outside director's number divided by board size(number) at time.
Board Size	=	is operationalized as board number at time.
OCF	=	is operationalized as operating cash flow divided by assets at time.
LEV	=	is operationalized as the ratio liability to assets at time.
PPE	=	is operationalized as fixed asset, less land, less construction in progress, divided by assets at time.
SIZE	=	Ln(employee) at time.
AGE	=	Ln(number of years) at time.

Dependent variable. This study considers market based performance operationalization for corporate performance. Consistent with most prior literatures on the firm value and market value, performance

is operationalized by the Tobin's Q (Su and Fung, 2013, Lim et al., 2015). It is operationalized as asset book value, less equity book value, plus equity market value, divided by asset book value

Independent variable. To explore the effect of political directors on corporate performance, the present study utilizes two variables for examining the political directors. Firstly, political dummy variable is a dummy that equals to 1 if at least one political connections of outside-director on the board, 0 otherwise (Su et al., 2013). Secondly, we operationalize political connections for political ratio which is the number of political connections of outside-director divided by number of board of directors (Amon et al., 2015).

Control variables. We use control variables related to the firm-characteristic factors that would affect firm performance. First, we use three variables as proxies for the ownership, namely foreigner ownership, Board independence, and board size. Foreign ownership is operationalized by ownership owned by foreign investor, board independence is operationalized outside director's number divided by board size (number), and board size, operationalized by the number of board (Kang and Zhang 2015). Second, we also some variables as proxies for the firm characteristics which are operating cash flow, leverage, PPE, firm size, and firm age. Operating cash flow is operationalized as operating cash flow divided by asset book value (Lim et al., 2015). Leverage is operationalized by liability divided by assets (Su and Fung, 2013). PPE means that assets, operationalized by fixed asset, less land, less construction in progress, divided by assets. Firm size is operationalized by Ln (employees) and firm age is operationalized by Ln (the number of years).

3.2.2 Analysis Model of Operating Cash Flow (Cash generating-ability)

There are two operationalization of firm performance. 1) Operating Cash Flow, as operationalization of cash generating-ability from operating activities. 2) Return on Assets as operationalization of accounting performance. One important aspect of a company's performance evaluation is its ability to generate cash flow. Therefore, we additionally examine the operationalization of cash generating-ability. We develop the following regression to operationalize cash generating-ability.

(2)

$$OCF_{it+1} = \beta_0 + \beta_1 \times Political\ Dummy\ (or\ Political\ Ratio)_{it} + \beta_2 \times FFO_{it} + \beta_3 \times Board\ Independence_{it} + \beta_4 \times Board\ Size_{it} + \beta_5 \times LEV_{it} + \beta_6 \times PPE_{it} + \beta_7 \times SIZE_{it} + \beta_8 \times AGE_{it} + \varepsilon_{it}$$

Where,

OCF_{it+1}	=	is operationalized as operating cash flow divided by assets at time 1.
Political Dummy	=	is a dummy that if at least one Political director on the board we coded 1, 0 otherwise at time.
Political Ratio	=	is the number of Political director divided by number of board of directors at time.
FFO	=	is operationalized as foreigner ownership at time.
Board Independence	=	is operationalized as outside director's number divided by board size(number) at time.
Board Size	=	is operationalized as board number at time.
LEV		is operationalized as the ratio liability to asset at time.
PPE	=	is operationalized as fixed asset, less land, less construction in progress, divided by assets at time.
SIZE	=	Ln(employee) at time.
AGE	=	Ln(number of years) at time.

Dependent variable. This study considers not only market performance but also cash generating-ability operationalization for corporate performance. Operating Cash flow is operationalized by operating cash flow divided by assets (Lim et al., 2015).

Independent variable. The present study utilizes two variables to investigate the influence of political directors on their cash generating-ability. Firstly, political dummy variable is a dummy that equals to 1 if at least one political connections of outside-director on the board, otherwise 0 (Su and Fung, 2013). Secondly, we operationalization political connections for political ratio which is political directors' number divided by board of directors (number) (Amon et al., 2015).

Control variables. Use control variables related to corporate special factors that can affect the performance of a company. First, foreigner ownership is operationalized by percentage of foreigner ownership (Lim et al., 2015). Second, Board independence is operationalized as outside director's number divided by board size (number). Third, board size, operationalized by the number of board (Kang and Zhang 2015). Forth, we control leverage, operationalized by liability divided by assets (Su et al., 2013). Fifth, PPE is operationalized by the assets, operationalized by fixed asset, less land, less construction in progress, divided by assets. Lastly, given that the results of previous study that size [Ln (employees)], age [Ln (the number of years)] are related to firm performance.

3.2.3 Analysis Model of ROA (Accounting Performance)

ROA is perhaps the most common operationalization of corporate performance in accounting and finance literatures. Therefore, we check the relation between Political directors and book based performance as ROA. We make following equations to examine between Political directors and accounting performance.

(3)

$$ROA_{it+1} = \beta_0 + \beta_1 \times Political\ Dummy\ (or\ Political\ Ratio)_{it} + \beta_2 \times FFO_{it} + \beta_3 \times Board\ Independence_{it} + \beta_4 \times Board\ Size_{it} + \beta_5 \times LEV_{it} + \beta_6 \times PPE_{it} + \beta_7 \times SIZE_{it} + \beta_8 \times AGE_{it} + \varepsilon_{it}$$

Where,

ROA_{it+1}	=	is operationalized as bottom-line divided by assets at time 1.
Political Dummy	=	is a dummy that if at least one Political director on the board we coded 1, 0 otherwise at time.
Political Ratio	=	is the number of political director divided by number of board of directors at time.
FFO	=	is operationalized as foreigner ownership at time.
Board Independence	=	is operationalized as outside director's number divided by board size(number) at time.
Board Size	=	is operationalized as the number of board at time.
LEV	=	is operationalized as liability divided by assets at time.
PPE	=	is operationalized as fixed asset, less land, less construction in progress, divided by assets at time.
SIZE	=	Ln(employee) at time.
AGE	=	Ln(number of years) at time.

Dependent variable. This chapter, we also consider accounting performance based on accrual basis as operationalized ROA. Return on Asset (ROA) is operationalized as bottom-line divided by assets.

Independent variable. To analyze the impact of political directors on accounting performance, the present study utilizes two variables for examining the political directors Firstly, political dummy variable is a dummy that equals to 1 if at least one political director on the board (Su and Fung, 2013). Secondly, we operationalize political connections for political ratio which is number of political director divided by number of board of directors (Amon et al., 2015).

Control variables. We use control variables related to the firm-characteristic factors that would affect firm performance. First, foreigner ownership is operationalized by percentage of foreigner ownership (Lim et al, 2015). Second, board independence is operationalized as outside director's number divided by board size (number). Third, board size, operationalized by the number of board (Kang and Zhang 2015). Forth, we control leverage, operationalized by liability divided by assets (Su et al., 2013). Fifth, PPE is operationalized by fixed asset, less land, less construction in progress, divided by assets. Lastly, given that the results of previous study that size [Ln (employees)], age [Ln (number of years)] are related to firm performance.

4. Empirical Results

4.1 Descriptive Statistics

Tables 1 show a summary of the descriptive statistics for the variables used in this study. The average Q is 1.099 suggesting firms did create values for the shareholders' and the firm has positive NPV which having good expectations for future performance. The average OCF is 4.5% means that sample firms have on average 4.5% to assets. The average ROA is 1.2% also means that sample firms have on average book based performance. The mean of political dummy shows that about 42%. This means that KOSPI firms have at least one political connection of outside-directors. Furthermore, the mean of political ratio means that firms have around 10% former government officials on the boards. The average of FFO is 10.4%, which means the foreign ownership. The average of board independence and board size are 0.321. This is considered to be indicating outside director number among board size (number). The average of board size is 6.675 suggesting the number of board. The average of leverage and PPE is 43.9%, 16.4%, respectively.

4.2 Political Connections by Industry Distribution

Table 2 provides the industry distribution based on KRX big class level of the standard industrial classification. Manufacturing is the largest sector (5,580 observations, 71.6%). This study find that industries with higher level of political connections are construction field (67%), Electronics, Gas, Steam, Water Supply (60%), and Professional, Scientific and technical activities (56%) in order. It assumes that these industries are heavily related to government policy. This also suggests that firms in the industries with strict regulatory environment have more politicians than firms in less regulated industries. Therefore, we suppose that firms with highly political connections have strong incentive to seek former government officials.

4.3 Correlation Test

Table 3 shows that the Pearson correlation matrix. This study examines the correlation between Q, OCF, and ROA as dependent variables. Q, OCF, and OCF are positively correlated with ROA. However, the result is no significant correlation between Q and ROA. The correlation between political dummy and political ratio is some high (0.844). Although the correlation coefficient between the two variables is high, it seems that there is no problem because it is used alternately. Apart from

this result, the rest of correlation coefficient ranges between 0.487 (between board independence and political ratio) and -0.064 (between political ratio and age). And it shows that there is a significant or non-significant correlation among variables. But the coefficients is not exceed at 0.500 despite there is significant correlation among variables and the number of sample (395) does go far enough. To capture a multicollinearity problem among independent variable, we operationalize a VIF. It shows that our data is within the statistics' tolerance (3.914). This study concludes that there are no multicollinearity issues in the data.

4.4 The Effect of Political Connections on Tobin's Q

In this chapter, we examine the effect of political directors on market value. As shown above, equation (1) is a panel model that the dependent variable is Tobin's Q as operationalization of market value and the independent variable is political directors (political dummy and political ratio) with control variables. Table 4 presents that the result of the effect of political directors on firm value (Q). Model (1) is the effect of political dummy on the Tobin's Q with panel analysis. Model (2) examines the relation between political ratio and Tobin's Q. Model (3) and Model (4) are included industry fixed effect, year effect and clustered by firm. Peterson (2009) found that the correct way to estimate the standard error. When residuals are correlated through observations, OLS standard errors can be biased and underestimated or underestimated the actual variability of the coefficient estimates. Following his paper, we put standard errors clustered by firm in Column 3 and 4.

The results are as follows:

Firstly, In Model (1) and Model (3), political dummy is negatively and statistically significant impact on Tobin's Q at 1% and 5% level respectively (Model (1) coefficient: -0.131 and Model (3) coefficient: -0.133). Model (1) results suggesting that the coefficient estimate on the dummy variable for firms with political dummy is significant -0.131, implies that firm value for firms with political connections are approximately 13% lower than for firms without political connection. This result can be regarded as supporting the rubber stamp views in Korea. Rubber stamp views are not the role of political directors to monitor and advise, but rather take on the role of unconditional support for CEO decisions. However, my result is partially different from that of Lim et al. (2015). Lim et al. (2015) did not find significant differences in corporate value between when companies without ex-bureaucrat outside directors appoint former government officials as outside directors and when companies with political directors do not re-appoint them as outside directors. Furthermore, the companies with higher percentage of political directors are significantly lower in corporate value than the companies with

lower percentage of political directors. This result is also inconsistent with Su and Fung (2013). They found that the firms with political connections are positively impact on firm value (Q). Maybe it causes difference in structural characteristics of board of directors between Korea and China.

Secondly, In Model (2) and Model (4), political ratio is negatively and statistically significant impact on Tobin's Q at 1% and 1% level respectively (Model (2) coefficient: -0.589 and Model (3) coefficient: -0.569). The result of Model (2), we also find that firms with high level of political connections are negatively affecting firm value. Furthermore, we develop Model (3) and (4) as panel analysis with industry fixed effect; year fixed effect and clustered by firm level. Our results still remain significantly negative after adjusting for firm effect. In terms of economic significance, we find that firm value for firms with political dummy is approximately 13% lower than for firms without political connection. In addition, we also find that firms with high level of political connections are negatively affecting firm value.

Overall, these illustrations imply that political directors negatively impact on firms' market value. This result supports the opinion that political connections negatively influence the firm market based performance.

Thirdly, in control variables, foreign ownership, board independence, leverage, and operating cash flow are positively impact on Tobin's Q. In contrast, PPE and firm age are statistically negative impact on Tobin's Q. Lim et al. (2015) and Su and Fung (2013) also reported a negative relation between firm size and Tobin's Q. However, Su and Fung (2013) reported a positive relation between leverage, size and Tobin's Q. On the other hand, Lim et al. (2015) reported a negative relation between leverage, size and Tobin's Q.

4.5 The Effect of Political Connections on Operating Cash Flow

One more important aspect of a company's performance evaluation is its ability to generate cash flow. Thus, we examine the association between political directors and cash generating-ability from operating activities in this section. However, operating cash flow is the operationalization of the amount of cash generated by a company's normal business operations without accrual basis income. Therefore, this paper extends to examine the operating cash flow for firm performance. Equation (2) is a regression model that the dependent variable is operating cash flow, operationalized as operating cash flow divided by assets (Lim et al., 2015). The independent variable is political directors (political

dummy and political ratio) with control variables.

Table 5 presents that the result of the effect of political directors on operating cash flow. Model (5) is the effect of Political Dummy on the OCF with OLS. Model (6) examines the relation between Political Ratio and OCF. Model (7) and Model (8) are included industry fixed effect, year effect and clustered by firm. Peterson (2009) found that the correct way to estimate the standard error. When residuals are correlated through observations, standard errors can be biased and underestimated or underestimated the actual variability of the coefficient estimates. Following his paper, we put standard errors clustered by firm in Column (3) and (4).

The results are as follows:

Firstly, In Model (1) and Model (3), political dummy is negatively and statistically significant impact on OCF at 5% and 10% level respectively (Model (1) coefficients: -0.008 and Model (3) coefficient: -0.007). Model (1) shows that the coefficient estimate on the dummy variable for firms with political dummy is significant -0.008, implies that firm value for firms with political connections are approximately 0.08% lower than for firms without political connection. This result is inconsistent with Su et al. (2013). They found that the firms with political connections are positively impact on cash holding. Maybe it also causes difference in structural characteristics of board of directors between Korea and China.

Secondly, In Model (2) and Model (4), political ratio is negatively and statistically significant impact on OCF at 5% and 10% level respectively (Model (2) coefficient: -0.03 and Model (4) coefficient: -0.03). The result of Model (2), we also find that firms with high level of political connections are negatively affecting OCF. Furthermore, we develop Model (3) and (4) as panel with industry fixed effect; year fixed effect and clustered by firm level. Our results still remain significantly negative after adjusting for firm effect. In terms of economic significance, we find that firm value for firms with political dummy is approximately 0.7% lower than for firms without political connection. In addition, we also find that firms with high level of political connections are negatively affecting OCF.

In other words, these illustrations suggest that political directors negatively impact on Cash generating-activity (OCF). This result supports the opinion that political connections have a negative effect on the ability of generating cash flow.

Thirdly, in control variables, PPE, foreign ownership, and firm size are positively impact on OCF. In contrast, leverage and firm age are statistically negative impact on OCF. The positive relation between firm size and OCF is the same as that of Su and Fung (2013), which analyze the relation between firm size and cash holding. However, since there is a significant negative relation between leverage and OCF, my result is the same as those of Su and Fung (2013) using cash holding. However, since there is a significant positive relation between PPE and OCF, this result is the different as those of Su and Fung (2013).

4.6 The Effect of Political Connections on ROA

Although we examine relation between political directors and cash generating-ability, we further test the association between political connections and accounting performance. The operationalization of accounting performance is ROA which is probably the most common operationalization of firm performance or firm values in accounting and finance literatures. Equation (3) is a regression model that the dependent variable is ROA as bottom-line divided by assets. The independent variable is political directors (political dummy and political ratio) with control variables.

Table 6 presents that the result of the effect of political directors on firm value. Model (1) is that the effect of political dummy on the return on assets (ROA) with panel. Model (2) examines the relation between political ratio and ROA. Model (3) and Model (4) are included industry fixed effect, year effect and clustered by firm. Peterson (2009) found that the correct way to estimate the standard error. When residuals are correlated through observations, OLS standard errors can be biased and underestimated or underestimated the actual variability of the coefficient estimates. Following his paper, we put standard errors clustered by firm in Column (3) and (4).

The results are as follows:

Firstly, only Model (1) political dummy is negatively and statistically significant impact on ROA at 5% level (Model (1) coefficient: -0.008). Model (1) presents that the coefficient estimate on the dummy variable for firms with political dummy is significant -0.008 implies that accounting based performance for firms with political connections are approximately 0.8% lower than for firms without political connection. However, Model (3) is statistically non-significant. The reasons for the difference between ROA and accounting performance are different basis. Because ROA is based on accrual and cash basis, but ROA is only operationalized cash basis performance. Moreover, accounting-based measurements are inherently short-lived, tap only past performance, and are more

likely to be managerial manipulation (Briloff, 1972; McGuire, Schneeweis, and Hill, 1986; Watts and Zimmerman, 1990). This result is the different from those of Su and Fung (2013). They showed a positive relation between political connections and ROA.

Secondly, there is no evidence that the relation between political ratio and ROA are not statistically significant (Model (2), (3)).

In summary, these illustrations suggest that political directors negatively impact on accounting based performance only model (1). This result is insufficient to support the view that political connections have a negative effect on ROA which is effect on the accounting based performance.

Thirdly, control variables with negative impact on ROA are leverage, board independence and firm age. In contrast, foreign ownership and firm size are statistically positive impact on accounting performance.

5. Discussion and Conclusion

We explore the impacts of political connections on the Korean firm performance, a crucial research topic that ignored by the literature. The results lend significant support to my expectation. I find that high level of former government officials on the outside-directors and presence are negatively related to Tobin's Q and operating cash flow (OCF) suggesting that high level of political directors and such presence may hurt firm value and OCF. On the other hand, high level of political directors is insignificantly associated with accounting performance (ROA), whereas the presence of the political directors is more likely to negatively influence accounting performance, highlighting the important role of political connections for firm performance.

Such findings provide insights and contributions for literature on the relation between political connections and the corporate performance. First of all, I represent one of the few attempts to analyze the performance implications of political connections among firms in South Korea. The present study contributes to the understanding of the political connection-firm performance link. I further offer the clear evidence that highlight the crucial role of political connections for firm performance. In spite of the theoretical assumption and common belief that political connections are positively related to corporate performance, most previous researches offer limited insights into this link as they have chiefly concentrated on the Chinese corporate performance (Chizema et al., 2015; Fan et al., 2007; Su and Fung, 2013; Zheng et al., 2015). On the contrary to Su and Fung (2013)'s research, our results suggest that firms with high level of political connections are negatively related to firm performance, complementing the gaps between empirical evidence and theoretical argument by exploring

performance implications of political connections in Korean context. Second, the present study utilizes the longitudinal data analysis with the fixed-effect model to reduce the omitted variable concerns that plague the political connection' study. I further offer more united pictures of political connections on corporate performance by considering several performance variables for instance Tobin's Q as market value, ROA as accounting performance, and OCF as cash generating-ability from operating activities.

Of course, my study is subject to limitations. First, I do not consider management process and styles that may affect the political connections and firm performance and how firms manage the firm governance system. The efficient management of risks and political connections may merit further research. Second, even if I represent politically connected firms in South Korea are more likely to have the poor firm performance, political connections may also have social costs. These costs are related to associated-party transactions and excessive investments, encouraging agency cost concerns. Such social costs are crucial factors to explore but the present study leaves this important factor for future research. Third, the sample is limited to Korea and thus the results cannot be generalized to all firms. Our findings represent that corporate governance is more likely to be associated with comprehension of the political connection' implications. Future studies should be conducted to cover firms in other countries to contrast the findings with those presented in this study. Moreover, comparative research that includes both changes in firm-level governance features and national governance features will be a fruitful arena for future research.

I also have important managerial implications. The findings represent that political connections in South Korea are negatively related to firm performance, implying that firms with high levels of political directors and the presence of political connections may hurt firm performance. Hence, appointing former government officials as outside directors may be inappropriate. In other words, instead of hiring former government officials to take advantages from the government, firms in South Korea should consider and appoint experts rather than political directors.

Table 1

Descriptive Statistics

Variables	N	Mean	SD	Min	Max
Q_{t+1}	1,580	1.099	0.620	0.438	4.722
OCF_{t+1}	1,580	0.045	0.062	-0.137	0.211
ROA_{t+1}	1,580	0.012	0.137	-1.515	3.364
Political Dummy $_t$	1,580	0.424	0.494	0.000	1.000
Political Ratio $_t$	1,580	0.093	0.129	0.000	0.600
FFO $_t$	1,580	0.104	0.145	0.000	0.897
Board Independence $_t$	1,580	0.321	0.166	0.000	0.917
Board Size $_t$	1,580	6.675	2.085	1.000	19.000
OCF $_t$	1,580	0.042	0.065	-0.277	0.328
LEV $_t$	1,580	0.439	0.219	0.005	1.577
PPE $_t$	1,580	0.164	0.125	0.000	0.825
SIZE $_t$	1,580	2.661	0.626	0.778	4.980
AGE $_t$	1,580	1.578	0.257	0.000	2.068

Note: *Q* is operationalized as asset book value, less equity book value, plus equity market value, divided by asset book value at time 1,.*OCF* is operationalized as operating cash flow divided by assets at time 1, *ROA* is operationalized by bottom-line divided by assets at time 1, *Political Dummy* is a dummy that equals to 1 if at least one Political director on the board, 0 otherwise at time, *Political Ratio* is Political director's number divided by board of directors' number at time, *FFO* is operationalized as foreigner ownership at time, *Board Independence* is operationalized as outside director number divided by board size(number) at time, *Board Size* is operationalized as board number at time, *OCF* is operationalized as operating cash flow divided by assets at time, *LEV* is operationalized as the ratio liability to assets at time, *PPE* is operationalized as fixed asset, less land, less construction in progress, divided by assets at time, *SIZE* is *Ln*(employee) at time, *AGE* is *Ln*(number of years). Q, OCF, and ROA are winsorized by 1% level in order to smoothing the outlier.

Table 2

Industry Breakdown of Full Sample

Industry	N	%	Mean	SD	Min	Max
Agriculture	16	1.0	0.107	0.088	0.000	1.000
Mining	4	0.3	0.000	0.000	0.000	0.000
Manufacturing	1,132	71.6	0.377	0.485	0.000	1.000
Electronics, Gas, Steam, Water supply	28	1.8	0.607	0.497	0.000	1.000
Construction	92	5.8	0.674	0.471	0.000	1.000
Wholesale/Retail trade	104	6.6	0.490	0.502	0.000	1.000
Transportation	56	3.5	0.357	0.484	0.000	1.000
Information and Communication	40	2.5	0.550	0.504	0.000	1.000
Professional, Scientific and technical activities	100	6.3	0.560	0.499	0.000	1.000
Business facilities management and business support services	4	0.3	0.250	0.500	0.000	1.000
Art, Sports and Recreation related services	4	0.3	1.000	0.000	1.000	1.000
	1,580	100.0				

Note: Industry category is based on the KRX big class level.

Table 3

Pearson Correlation Matrix

	1	2	3	4	5	6	7	8	9	10	11	12	13	VIF
1.Q	1													
2.OCF	0.13**	1												
3.ROA	0.03	0.20**	1											
4.Political Dummy	-0.01	-0.01	0.01	1										3.69
5.Political Ratio	-0.02	-0.02	0.04	0.84**	1									3.91
6.FFO	0.23**	0.21**	0.15**	0.24**	0.22**	1								1.50
7.Board Independence	0.10**	0.02	0.04	0.40**	0.49**	0.33**	1							1.49
8.Board Size	0.09**	0.11**	0.07**	0.28**	0.21**	0.34**	0.27**	1						1.28
9.OCF	0.14**	0.35**	0.31**	-0.02	-0.03	0.21**	0.03	0.09**	1					1.16
10.LEV	0.00	-0.18**	-0.34**	0.07**	0.10**	-0.15**	0.08**	-0.02	-0.23**	1				1.19
11.PPE	-0.04	0.19**	-0.01	0.01	0.02	0.08**	0.06*	0.15**	0.16**	0.14**	1			1.13
12.SIZE	0.12**	0.17**	0.08**	0.35**	0.35**	0.48**	0.40**	0.37**	0.16**	0.16**	0.25**	1		1.71
13.AGE	-0.08**	-0.07**	-0.04	-0.11**	-0.06*	-0.03	0.01	0.05*	-0.10**	-0.01	0.02	-0.05	1	1.04

Note: 1. *Q* is operationalized as asset book value, less equity book value, plus equity market value, divided by asset book value at time 1. *OCF* is operationalized as operating cash flow divided by assets at time 1. *ROA* is operationalized by bottom-line divided by assets at time 1. *Political Dummy* is a dummy that equals to 1 if at least one Political director on the board, 0 otherwise at time, *Political Ratio* is Political director's number divided by board of directors' number at time, *FFO* is operationalized as foreigner ownership at time, *Board Independence* is operationalized as outside director's number divided by board size(number) at time, *Board Size* is operationalized as board number at time, *OCF* is operationalized as operating cash flow divided by assets at time, *LEV* is operationalized as the ratio liability to assets at time, *PPE* is operationalized as fixed asset, less land, less construction in progress, divided by assets at time, *SIZE* is *Ln(*employee) at time, *AGE* is *Ln*(number of years).

2.*, ** indicate significance at the 5%, and 1% level.

Table 4

The Effect of Political Connections on Tobin's Q

Q	Model (1)	Model (2)	Model (3)	Model (4)
Political Dummy	**-0.131*** **		**-0.133** **	
	(0.035)		**(0.055)**	
Political Ratio		**-0.589*** **		**-0.569*** **
		(0.137)		**(0.211)**
FFO	0.914***	0.901***	0.839**	0.822**
	(0.126)	(0.126)	(0.405)	(0.404)
Board Independence	0.203*	0.276**	0.127	0.190
	(0.105)	(0.110)	(0.166)	(0.169)
Board Size	0.011	0.009	0.006	0.003
	(0.008)	(0.008)	(0.013)	(0.012)
OCF	0.999***	0.991***	0.973***	0.969**
	(0.248)	(0.247)	(0.447)	(0.450)
LEV	0.200***	0.203***	0.362***	0.355***
	(0.075)	(0.075)	(0.130)	(0.130)
PPE	-0.453***	-0.453***	-0.462**	-0.463**
	(0.127)	(0.127)	(0.216)	(0.215)
SIZE	0.015	0.019	0.0514	0.056
	(0.031)	(0.031)	(0.072)	(0.074)
AGE	-0.184***	-0.174***	-0.164*	-0.153
	(0.059)	(0.059)	(0.098)	(0.099)
Constant	1.114***	1.081***	1.000***	0.956***
	(0.122)	(0.122)	(0.247)	(0.248)
Industry FE	NO	NO	YES	YES
Year FE	NO	NO	YES	YES
Observations	1,580	1,580	1,580	1,580
R-squared	0.085	0.088	0.147	0.148

Note: 1. all variables are defined as before.
2. ***, ** and * indicate the significance at the 1%, 5%, and 10% levels respectively.
3. Standard error in parenthesis.

Table 5

The Impact of Political Connections on Operating Cash Flow

OCF	Model (1)	Model (2)	Model (3)	Model (4)
Political Dummy	**-0.008****		**-0.007***	
	(0.003)		**(0.004)**	
Political Ratio		**-0.032****		**-0.028***
		(0.013)		**(0.016)**
FFO	0.052***	0.051***	0.049*	0.048*
	(0.012)	(0.012)	(0.026)	(0.025)
Board Independence	-0.017	-0.014	-0.016	-0.013
	(0.010)	(0.011)	(0.013)	(0.013)
Board Size	0.001	0.001	0.001	0.000
	(0.001)	(0.001)	(0.001)	(0.001)
LEV	-0.055***	-0.055***	-0.056***	-0.056***
	(0.007)	(0.007)	(0.010)	(0.010)
PPE	0.089***	0.089***	0.092***	0.092***
	(0.012)	(0.012)	(0.018)	(0.018)
SIZE	0.013***	0.013***	0.012**	0.012**
	(0.003)	(0.003)	(0.005)	(0.005)
AGE	-0.018***	-0.017***	-0.017*	-0.016
	(0.006)	(0.006)	(0.010)	(0.010)
Constant	0.047***	0.046***	0.021	0.019
	(0.012)	(0.012)	(0.024)	(0.024)
Industry FE	NO	NO	YES	YES
Year FE	NO	NO	YES	YES
Observations	1,580	1,580	1,580	1,580
R-squared	0.125	0.125	0.143	0.143

Note: 1. all variables are defined as before.
2. ***, ** and * indicate the significance at the 1%, 5%, and 10% levels respectively.
3. standard error in parenthesis.

Table 6

The Impact of Political Connections on Return on Assets

ROA	Model (1)	Model (2)	Model (3)	Model (4)
Political Dummy	**-0.008****		**-0.007**	
	(0.004)		**(0.005)**	
Political Ratio		**-0.021**		**-0.019**
		(0.015)		**(0.018)**
FFO	0.0354**	0.0347**	0.0401	0.0396
	(0.0138)	(0.0138)	(0.0255)	(0.0255)
Board Independence	0.036***	-0.036***	0.042***	-0.041***
	(0.012)	(0.012)	(0.015)	(0.015)
Board Size	0.000	0.000	-0.000	-0.001
	(0.001)	(0.001)	(0.001)	(0.001)
LEV	-0.117***	-0.117***	-0.106***	-0.106***
	(0.008)	(0.008)	(0.016)	(0.016)
PPE	0.015	0.016	-0.011	-0.012
	(0.014)	(0.014)	(0.019)	(0.019)
SIZE	0.020***	0.020***	0.022***	0.022***
	(0.003)	(0.003)	(0.006)	(0.006)
AGE	-0.021***	-0.020***	-0.017	-0.016
	(0.006)	(0.006)	(0.011)	(0.011)
Constant	0.053***	0.052***	0.060**	0.058**
	(0.013)	(0.013)	(0.023)	(0.024)
Industry FE	NO	NO	YES	YES
Year FE	NO	NO	YES	YES
Observations	1,580	1,580	1,580	1,580
R-squared	0.170	0.169	0.198	0.197

Note: 1. all variables are defined as before.
2. ***, ** indicate the significance at the 1%, 5% levels respectively.
3. standard error in parenthesis.

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